

**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

)	
Petition of Western Massachusetts Electric Company)	
for authorization and approval of the issue and sale of)	
long-term debt securities in an amount not to exceed)	D.T.E. 02-49
\$105 million in principal, pursuant to G.L. c. 164, § 14,)	
and exemption from the competitive bidding requirements)	
of G.L. c. 164, § 15.)	
)	

**INITIAL BRIEF
OF THE ATTORNEY GENERAL**

Respectfully submitted,

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I. INTRODUCTION

A. SUMMARY

Western Massachusetts Electric Company (“WMECo” or the “Company”) petitions the Department of Telecommunications and Energy (“Department”) for: (1) authorization pursuant to G.L. c.164, §14, to issue up to \$105 million in long-term debt; (2) exemption from advertising and competitive bid requirements under G.L. c.164, §15, in connection with this proposed debt; and (3) approval to engage in hedging activities with respect to any current or future debt obligations pursuant to G.L. c. 164, §14.

The Department should grant WMECo’s request for authority to issue up to \$105 million in long-term debt. The Department, however, should not grant WMECo authority: 1) to establish a separate trust to pay Prior Spent Nuclear Fuel (“PSNF”) obligations;¹ or 2) to invest in such a

¹ The PSNF obligations arise from the Company’s prior partial ownership of the Millstone nuclear plant in Waterford, Connecticut. Pursuant to the Nuclear Waste Policy Act of 1982, WMECo is required to pay the United States Department of Energy (“DOE”) one mil (one-tenth of a cent) per net kilowatt-hour generated by the plant for the disposal of spent nuclear fuel and radioactive waste

trust. WMECo did not petition the Department for written approval as required by G.L. c. 164, §17A, and the investment, as described by WMECo, would result in harm to customers.

The Department should also deny WMECo's request for authority to engage in hedging activities with respect to any current or future debt obligations. The proposal would introduce the potential for gaming and unfair dealing and add to the Company's risk profile.

B. PROCEDURAL BACKGROUND

On September 6, 2002, WMECo filed its Petition with the Department, together with supporting testimony of Randy A. Shoop, the Company's Assistant Treasurer. Exh. WM-1. On October 29, 2002, the Department held a public hearing and procedural conference. On December 12, 2002, the Company revised or otherwise amended its Petition and related testimony by filing the supplemental testimony of Mr. Shoop, Exh. WM-2.² On February 25, 2003, the Department held an evidentiary hearing during which the Company offered the testimony of Mr. Shoop and Jeffrey R. Cahoon, Director of Revenue Requirements of Northeast Utilities Services Corporation, in support of its Petition.

II. STANDARD OF REVIEW

Authorization To Borrow

Before approving the issuance of stock, bonds, coupon notes, or other types of long-term indebtedness by an electric or gas company, the Department must determine that the proposed

produced at Millstone during the Company's prior partial ownership. The Company sold Millstone to Dominion Resources, Inc. ("Dominion") in March 2001, but retains the disposal liabilities from prior to the sale.

² The Company also included with the supplemental testimony: (1) Draft Trust Agreement; (2) Draft Investment Policy for Trustee; (3) Revised Net Plant Analysis; and (4) Revised Pro Forma Financial Statements for Northeast Utilities ("NU").

issuance meets two tests.³ G.L. c. 164, §14.

- First, the Department must assess whether the proposed issuance is “reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency.” *Fitchburg Gas & Electric Light Company v. Department of Public Utilities*, 395 Mass. 836, 842 (1985) (“*Fitchburg II*”), citing *Fitchburg Gas & Electric Company v. Department of Public Utilities*, 394 Mass. 671, 678 (1985) (“*Fitchburg I*”) and *Lowell Gas Light Co. v. Department of Public Utilities*, 319 Mass. 46, 52 (1946).
- Second, the Department must determine whether the Company has met the Department’s “net plant test” derived from G.L. c. 164, § 16. To satisfy the net plant test, a company must present evidence showing that its net utility plant (original cost of capitalizable plant less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding, exclusive of retained earnings) and will continue to do so following the proposed issuance. *Colonial Gas Company*, D.P.U. 84-96, p. 5 (1984).

Authorization To Invest Funds

A different statute governs the authority of a gas or electric utility to **invest**. To invest, a gas or electric company must obtain written Department approval in order to “loan its funds to, guarantee or endorse the indebtedness of, or invest its funds in the stock, bonds, certificates of participation or other securities of, any corporation, association or trust....” *See, e.g., Bay State Gas Company*, D.T.E. 99-23, p. 4 (1999); G.L. c. 164, § 17A.

The legal standard for investments under Section 17A is different from the “reasonably necessary” standard that applies to borrowings under Section 14. Under Section 17A, investments must be “consistent with the public interest.” The Department has indicated that it will approve a Section 17A proposal if the public interest is at least as well served by approval of

³ An electric or gas company offering long-term bonds or notes in excess of \$1 million in face amount must also invite purchase proposals through newspaper advertisements. G.L. c. 164, § 15. The Department may grant an exemption from this advertisement requirement if the Department finds that an exemption is in the public interest. G.L. c. 164, § 15.

the proposal as by its denial. *Southern Union Company*, D.T.E. 03-3, p. 8 (2003); *Massachusetts Electric Company*, D.T.E. 01-104, p. 4 (2002), citing *Bay State Gas Company*, D.P.U. 91-165, p. 7 (1992); see *Boston Edison Company*, D.P.U. 850 (1983). The Department interprets the facts of each §17A case on its own merits in determining whether the proposal is consistent with the public interest. *Id.* The Department bases its determination on the totality of what can be achieved rather than on any single gain that could be derived from the proposed transactions. *Id.*; see D.P.U. 850, p. 7. The Department has found that the public interest standard best accommodates its interest in protecting the utility's ratepayers from the adverse effects of unwarranted §17A transactions and a utility's interest in having flexibility in a changing marketplace to meet long term objectives of its ratepayers and shareholders. *Id.*; *Boston Edison Company*, D.P.U. 97-17, p. 6 (1997).

The Department thus considers the overall anticipated effect on ratepayers of the potential harms and benefits of an investment proposal. *Id.*; D.P.U. 91-165, p. 8. The Department may consider a number of factors, including, but not limited to, the nature and complexity of the proposal, the relationship of the parties involved in the underlying transaction, the use of the funds associated with the proposal, the risks and uncertainties associated with the proposal, the extent of regulatory oversight on the parties involved in the underlying transaction, and the existence of safeguards to ensure the financial stability of the utility. *Id.*, p. 5.

III. ARGUMENT

A. THE DEPARTMENT SHOULD APPROVE THE COMPANY'S REQUEST TO ISSUE \$105 MILLION IN LONG TERM DEBT.

The Department should approve the Company's request to issue \$105 million in long

term debt. WMECo has enough total net plant investment to meet the Department's net plant test for the originally requested \$105 million bond issue.⁴ Tr. 1, pp. 125-129. An issuance in that amount would provide the Company with the necessary funds to refinance its outstanding short-term debt and finance new construction. The borrowing also would improve WMECo's capital structure by increasing its debt to equity ratio and decreasing the overall weighted cost of capital for the Company and its customers. *Id.*, p. 54.

The Attorney General, however, objects to WMECo's proposal to use \$48 million of the financing proceeds to fund a PSNF trust. Exh. WM-1, p. 2.

B. THE DEPARTMENT SHOULD NOT AUTHORIZE WMECO EITHER TO CREATE, OR INVEST FUNDS IN, A SPENT NUCLEAR FUEL TRUST.

1. The Department Should Not Authorize WMECo To Create, Or Invest Funds In, A Spent Nuclear Fuel Trust Because The Company Has Not Petitioned For That Authority.

In this case, the PSNF trust issues are not even properly before the Department. A gas or electric company must obtain written Department approval in order to "loan its funds to, guarantee or endorse the indebtedness of, or invest its funds in the stock, bonds, certificates of participation or other securities of, any corporation, association or trust..." *See, e.g., Bay State Gas Company*, D.T.E. 99-23, p. 4 (1999). G.L. c. 164, § 17A. In its filing, WMECo did not petition for written approval to establish a PSNF trust or to invest any funds in such a trust, as required by statute. G.L. c. 164, §17A. Petition; Tr., pp. 16-17. To obtain authority to invest under G.L. c. 164, §17A, WMECo is required to file an affirmative petition. Merely listing trust

⁴ WMECo's liability for PSNF obligations cannot enter into the net plant test analysis, since it is not net plant. The Spent Nuclear Fuel Plant Asset has been fully amortized and therefore has a zero balance on the Company's books.

funding as a proposed use of proceeds from the financing under G.L. c. 164, §14, and discussing various aspects of a PSNF trust, are not legally sufficient to constitute a petition. The current filing does not establish that the investment would be “consistent with the public interest. *See* Petition, pp. 1-2; Exh. WM-1, WM-2.

2. Funding The Spent Nuclear Fuel Trust As Described By WMECo Would Be Harmful To Customers.

The change to a PSNF trust as described by WMECo also would harm customers. WMECo would remove from the balance of unrecovered investments the \$48 million *credit* for spent nuclear fuel costs that the Company has already recovered from its customers as a component of its reconciling fuel charge, all of the monies that will be owed to DOE.⁵ Tr., pp. 33-34. This would *increase* the balance of investment upon which the Company earns a return at its pre-tax overall weighted cost of capital of 11.84 percent (assuming the Company issues the proposed bonds). Tr.1, pp. 55. The Company indicated that it would invest the PSNF funds in United States Treasury securities earning returns comparable to those of short-term risk-free investments that are currently achieving 1.3 percent returns. Exh. WM-1, p. 4 and Tr. 1, p. 34.

If WMECo were actually to take the investment steps it describes, it would effectively reduce by nearly an order of magnitude the interest rate that the Company pays on the \$48 million in funds previously contributed by ratepayers, from 11.84% to around 1.3%. This change would result in an *increase* to the annual transition charge revenues paid by customers of

⁵ WMECo would have to petition for, and obtain, expressed Department approval after evidentiary hearings before it could remove the \$48 million credit, which was previously approved by the Department as a transition cost mitigation measure. G.L. c. 164, §1A(b)(1); §1G(d)(1); §1H (b)(2).

approximately \$5 million annually. [\$48 million X (0.1184 - 0.013) = \$5 million]. Customers would likely have to pay that additional annual cost from the time WMECo invests in the trust until DOE actually takes the fuel and is paid from the trust, probably many years hence.

The Department, therefore, should reject the WMECo proposal. Because WMECo has already collected from customers the amount it will owe DOE, and the trust proposal would cause \$5 million per year harm to customers, the proposal is not consistent with the public interest. *Massachusetts Electric Company*, D.T.E. 01-104, p. 4 (2002) citing *Bay State Gas Company*, D.P.U. 91-165, p. 7 (1992); see *Boston Edison Company*, D.P.U. 850 (1983).

C. THE DEPARTMENT SHOULD DENY THE COMPANY'S PROPOSAL TO ENTER INTO THE FINANCIAL DERIVATIVES MARKETS.

The Company also asks the Department to allow it to trade financial derivatives. Petition, p. 5; Exh. WM-1. WMECo proposes that its shareholders bear the costs, gains, and losses associated with the trading. Exh. WM-1; Tr., p. 33, 67. The Department should deny the Company's request because the proposal would harm customers.

1. The Trading Of Financial Derivatives Is Not Necessary For The Provision Of Utility Service.

WMECo asks the Department to grant it blanket approval to trade financial derivatives. Petition, p. 5; Exh. WM-1. Under G.L. c. 164, § 14, the Department must determine whether the Company's request and related use of the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations. *Fitchburg Gas & Electric Light Company v. Department of Public Utilities*, 395 Mass. 836, 842 (1985) ("*Fitchburg II*"), citing *Fitchburg Gas & Electric Company v. Department of Public Utilities*,

394 Mass. 671, 678 (1985) ("*Fitchburg I*"). The Company's hedging proposal does not meet the test as a "legitimate purpose" in meeting its service obligations. It would benefit only shareholders, while harming ratepayers by increasing the investment risk profile of the Company.

The Company does not propose any limits on the trades, either in types of derivatives traded, the dollar amount traded, the value at risk, or the persons doing the trading. Tr., pp. 17-28. The only limits on trading identified by the Company's witness were that trading would be for hedging purposes only and would not be "speculative" in nature according to accounting standards. *Id.*, p. 20. The Company claims that its trading of derivatives will be limited by Financial Accounting Standards Board Accounting Standard Number 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133") and that it will refrain from doing "speculative" trading.

Clearly, the accounting standards do not limit the trading activities of a corporation, but merely prescribe the methodologies that the Company should use *to account for* those derivative trading activities in order to conform with Generally Accepted Accounting Principles. See FAS 133. Even in the situation where the Company seeks to "limit" itself to hedging activities as defined by FAS 133, that measurement of the limits happens only four specific times a year when the Company makes its financial reports at the end of each quarter. During the other 360 days of each year, the Company could undertake speculative trading without any limitations. The Department should deny the Company's blanket request to trade financial derivatives because it does not serve a "legitimate utility purpose" and will increase WMECo's investment risk profile, harming customers by increasing capital costs.

2. The Company's Proposal To Retain The Benefits Of Its Proposed Financial Trades Will Harm Customers Since It Puts WMECo's Interests In Direct Conflict With Those Of Its Customers.

WMECo's proposal to trade financial derivatives would harm customers. The Company proposes to retain all of the gains and all of the losses of derivatives trading. Tr. 1, p. 33. The gains and losses would depend on the interest rates associated with the Company's securities. Since the Company would also be negotiating the terms of the securities issues, including the maturity, interest rate, and fixed versus variable components, WMECo would have a strong incentive to get the worst results for customers in negotiating the original terms of the instrument, only to turn around and use derivative securities to reverse the terms of the instrument so that its shareholders would profit from the correction. Two simple examples illustrate the inherent conflict of having an incentive mechanism where a utility negotiates the benchmark, in this case the terms of the instrument, as well as the derivatives from which it profits.

First, when the Company believes that long-term interest rates will trend down in the future, it would issue long-term bonds with a fixed interest rate and then, immediately after issuing the bonds, trade over-the-counter to swap its fixed interest rate for a variable interest rate instrument. This scheme would burden customers with the higher fixed rate debt, while allowing the Company to benefit from "riding the curve" as interest rates decrease in the future. Inversely, when the Company believes that interest rates will increase in the future, it would issue variable interest rate bonds to the market and immediately afterwards swap the variable for a fixed investment rate instrument. This scheme would burden customers with higher costs as interest

rates rise over time, and the Company's shareholders would profit from having swapped to fixed instruments.

These examples demonstrate the ease with which the Company could profit inappropriately from its financing and hedging activities in ways that guarantee that its customers would lose, since the utility would always be trading against the economics of the original issue.

3. The Company Has Neither The Necessary Human Resources Nor The Experience To Trade Financial Derivatives.

The Department should deny WMECo's proposal to trade financial derivatives because the Company does not have the necessary expertise to trade financial derivatives. The NU employees who would be performing the hedging activities for the Company have practically no experience in trading financial derivatives and are neither trained nor licensed to perform financial derivative trades. See Tr. 1, pp. 12 - 15 and pp. 18 -19. The sum total experience of the employees who would be authorized to perform the trades is "four or five" transactions that were performed over the last several years. Tr. 1, pp. 18-19. Even so, the Company proposes to allow these employees to trade any financial derivatives, in any amounts. The Department should deny the Company's request to enter into hedging activities, because it lacks the necessary experience in trading financial derivatives and that inexperience could cause severe financial harm to the Company.

4. The Company Does Not Have A Risk Management Policy In Place That Guarantees The Financial Health Of The Company.

WMECo does not have a corporate policy in place to provide the Department with the necessary assurances that the Company could sufficient monitor and limit the proposed derivatives trading activities to guarantee the financial health of the Company. The Company is

still in the process of creating a policy for approval by the NU Board. Tr. 1, p. 92-94, 103-105.

Although the Company provided a draft of the proposed policy in its response to discovery in this case, Mr. Shoop testified that WMECo is still making major changes to the wording of the policy and does not anticipate that it will have a final version until after the Department issues a decision in this case. Tr., pp. 103-105. Without a clear and definite understanding of any policies the Company may have to govern its financial derivatives trading, the Department should not allow the Company to trade financial derivatives.

IV. CONCLUSION

The Department should authorize WMECo's request to issue up to \$105 million in long-term debt. The Department should not authorize the creation of, or any investment in, a spent nuclear fuel trust, because the Company has not petitioned for such written authority as required under G.L. c.164, §17A, and funding of the trust would not be in the public interest. The Department should also deny WMECo's request to allow it to trade financial derivatives, since it would harm the Company's customers.

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